Estate Planning For Business Owners

By,

Pattie S. Christensen, Esq.

Owners and operators of businesses have additional estate planning concerns, both during life and after death.

During the business owner's life, his primary concerns may include: ensuring maximum asset protection, ensuring that the business does not fall into the wrong hands, training family members to work in the business or to own business interests, planning for taxes and providing wealth replacement or other strategies to protect against business downturns.

When a person owns a business rather than simply working for someone else, that business owner has substantially greater risk from an asset protection standpoint than a wage-earning employee. The business owner has greater risk of being sued by suppliers, customers, employees and others. There are many ways that business owners can minimize that risk. One of the primary methods of asset protection is by forming a separate legal entity to own the business. The type of entity that is chosen depends on a number of factors including tax planning, transfer planning, operational planning and determining the complexity level that the business owner can handle. Common entity forms are limited partnerships, limited liability companies and corporations (both "C" corporations and "S" corporations).

The business owner needs to discuss with his estate planning professional the various advantages and disadvantages of the different types of entities and needs to determine which entity type is appropriate for the business owner in light of his circumstances. This may include having more than one entity, such as one company for operating the business and a separate company for holding the real estate.

Business owners, especially those who have built their companies from scratch, are naturally concerned with who owns and will own the business. For this reason, many business owners choose to place restrictions on the transfer of business interests. This may be done in the entity's governing documents, such as in the operating agreement for a limited liability company. Or, restrictions on transfer may be accomplished through the use of "Buy-Sell Agreements" also known as "Shareholder Agreements". One common form of transfer restriction is to provide that if an owner desires to transfer his interest to anyone outside his immediate family (spouse and children), he must first present the company or the other owners with the opportunity to purchase those interests.

It used to be common to see restrictions on transfer in the form of absolute prohibitions on transfer without prior consent of the company. However, this method of restriction has fallen out of favor because it can have negative gift tax consequences.

In addition to being concerned with the transfer of interests during the business owner's life, he will likely be concerned with what will happen to the company upon his death. He may want family members to continue to run the company or he may want the company to be sold so that his family members have a readily available source of funds. Or the business owner may want to combine the two strategies by providing that certain family members purchase the business from the deceased owner's estate. In order to ensure that the family members have enough cash to purchase the business from the deceased owner's estate, the business owner may purchase life insurance payable to the family members who will be buying the business or the company may buy life insurance to buy out deceased owners.

One practical consideration of many business owners is how to train their family members to both own the family business and run the family business. For this reason and for tax reasons, it is common to see business owners slowly gift interests in the business to their family members. In this way the family members become more and more active in the business over time rather than simply inheriting a business on the business owner's death without proper planning. Even if the family member is not going to run the business but is simply going to own business interests, it is still common to see those interests gifted over time not just for gift tax reasons but also so the family member becomes accustomed to the impact that such giving of business interests can have on his or her personal financial situation including his or her income taxes and estate taxes.

Though most business owners are quick to transfer interests to their family members during their life, they are not however quick to give up control of the company during their life. For this reason the entity structure used for the business plays a significant role in controlling the operation of the company. For instance, if the entity structure chosen is a limited liability company, the business owner may be the manager of the company while he transfers non manager member interests to his family members. In other words, though his family members own a portion of the business, they do not participate in the day to day business decisions of the company. This may remain true even if the family members own in excess of fifty (50) percent of the ownership interest of the company. Similarly, if a limited partnership structure is used, the business owner will likely be the general partner while the family members may be limited partners. By separating the ownership interests from the decision making responsibilities, the business owner is better able to suit the needs of his family members. For instance there may be family members who are more inclined to operate the business while there are others who are more inclined to take a passive role.

One of the major considerations with owning and operating a business is how to properly structure the business for income tax purposes. Different types of entities have different tax structures. Many of you are likely familiar with the common C-corporation tax structure, which is used by major companies like Coca-Cola and IBM. In this type of

structure, the corporation pays taxes on its income then it makes distributions to the shareholders. The shareholders in turn then pay taxes on their dividends. This tax structure is commonly referred to as "double taxation" because taxes are paid at both the corporate level and the shareholder level. For this reason the C-corporation structure is often less tax advantageous to a small business owner.

Instead, a business owner may elect at the formation of his corporation or at the beginning of a tax year to be treated as an S-corporation. In a nut shell what this means is that the individual owner or owners of a company have elected to treat the company as a partnership for income tax purposes even though it is a corporation for legal purposes. In other words all of the income and expenses of the company flow through to the individual shareholder tax returns so that there is only one level of income taxation. Similarly, both limited liability companies and limited partnerships are flow-through tax entities unless the owners specifically elect otherwise.

While both S-corporations and limited liability companies are flow-through entities there are subtle differences in their taxation. The primary difference is with an S-corporation some self employment tax may be eliminated by declaring a portion of the income as dividends rather than salary or wages. However, because the paperwork requirements and limitations of an S-corporation are substantially greater than with a limited liability company, it is necessary for the business owner to weigh the potential tax savings against the costs and hassles of a having a more complex entity.

Business owners are also understandably more concerned with their ability to provide for their families than a typical wage earner may be. This is because the business owner carries all of the weights and burdens of his business and his industry. For this reason the business owner may look more towards wealth replacement strategies than a typical wage earner would. The business owner may have different or more complex types of insurance than a wage earner. He may have business interruption insurance, disability insurance and other types of insurance.